

Decedent =  
Spouse =  
Son 1 =  
Spouse 1 =  
Son 2 =  
Spouse 2 =  
Son 3 =  
Daughter =  
Spouse 3 =  
Grandchild 1 =  
Grandchild 2 =  
Grandchild 3 =  
Grantor =  
Grantor's Spouse =  
Trust =  
Trustee =  
Year =  
Date 1 =  
Date 2 =  
Date 3 =  
a =  
b =  
c =

d =

e =

State =

State Statute #1 =

State Statute #2 =

Court =

Agreement =

Dear :

This is in response to a letter dated May 30, 2007, from your authorized representative, in which you request rulings concerning the gift, estate, and generation-skipping transfer (GST) tax consequences of a proposed settlement agreement and proposed disclaimers.

#### Facts

In Year, Grantor and Grantor's Spouse created the Trust for the benefit of Decedent. Year is prior to October 22, 1942. The instrument states that "[Grantor] and [Grantor's Spouse] are the parents of [Decedent] ... and it is the desire and purpose of the said [Grantor] and [Grantor's Spouse] to create an irrevocable trust, known as the [Decedent] Trust Estate, for the use and benefit of [Decedent]... ."

Article III, Section 1, provides that no beneficiary can require distribution of trust corpus or partition or termination of the trust.

Article III, Sections 2 and 3, state as follows:

Section 2: The death, insolvency or bankruptcy of the Beneficiary hereunder, or the transfer of his interest in any manner, or by descent or otherwise, during the continuance of this Trust, shall not operate as a dissolution of, nor terminate the Trust, nor shall it have any effect whatever upon said Trust Estate, its operation or mode of business, nor shall it entitle his heirs or assigns or representatives to take any action in the courts of law or equity against the Estate, its Trustees or property or its business operations of any kind, all of which shall remain intact and undisturbed thereby; but they shall succeed only to the rights of the original Beneficiary as herein set forth.

Section 3: At the time of the death of Beneficiary, his equitable interest in said Trust Estate, unless disposed of otherwise by said Beneficiary, shall pass to and vest in his heirs in accordance with the laws of descent and distribution then in force, applicable to the equitable interest of such Beneficiary in said Trust. (The term 'Beneficiary' applies not only to [Decedent] but to all his successors to beneficial interests under this trust).

Article IV, Section 3, provides that the Trust will terminate 21 years after Decedent's death, when the trustee will distribute the trust corpus among the then existing beneficiaries.

Article IV, Section 4, provides that the beneficiary may receive from time to time, a portion of the net profits accruing from time to time to the Trust, as the Trustee, acting with the advice and consent of the Advisory Board, may see fit to pay over and deliver to the beneficiary. No duty is imposed upon the Trustee to distribute net profits, but the power is conferred upon the Trustee, acting with advice and consent of the Advisory Board, to do so, and in exercising this discretion, the Trustee and Advisory Board must give full consideration to the interest of both the beneficiary and the Trust Estate.

Decedent died on Date 1, survived by Spouse, Son 1, Son 2, Son 3, and Daughter. Pursuant to Article VI, Section 3, the Trust will terminate on Date 2.

Pursuant to Article III and Article IV of the Trust, each Beneficiary has three separate interests in the Trust which passed to him or her on the Decedent's death: (1) the right to receive net profits in the discretion of the Trustee and the Advisory Board (the income interest); (2) the right to dispose of his or her share of the Trust if the Beneficiary dies before the Trust terminates on Date 2 (the power of appointment); and (3) the right to receive his or her share of the Trust if living on Date 2 (the remainder).

Spouse 1, Spouse 2, and Spouse 3 are each married to a child of Decedent. Under Article III, Section 3 of the Trust, if a child of Decedent dies prior to Date 2 (the termination date of the Trust), or disclaims any interest such child has in the Trust, Spouse 1, Spouse 2, and Spouse 3 would be entitled, as an heir of such respective deceased child of Decedent under the law of State, to succeed as a new beneficiary. Similarly, Spouse, Son 1, Son 2, Son 3, and Daughter are potential heirs under certain circumstances. The potential future heirs are collectively referred to as the New Trust Beneficiaries to the Trust. As a New Trust Beneficiary, each would have three separate interests, namely, an income interest, a power of appointment, and a remainder interest, referred to hereinafter as the Future Income Interest, Future Power of Appointment and Future Remainder Interest.

Questions have arisen regarding the meaning of certain terms and provisions in the Trust. In order to resolve the controversy without litigation, the parties have reached a settlement agreement, Agreement. Agreement resolves the ambiguities with respect to certain terms and modifies the Trust. During the negotiations that lead to the proposed Order (discussed below) that incorporates the Agreement, all of the beneficiaries of the Trust, including unborn and contingent beneficiaries, were represented by legal counsel (other than Spouse 2 who declined to be represented by counsel).

Agreement provides as follows:

I. At his death, [Decedent] had the unrestricted right to appoint his interest in the Trust.

II. At [Decedent's] death, his interest in the Trust passed to his heirs.

A. The identity of [Decedent's] heirs and the portion of the Trust each inherited was determined in accordance with the intestacy laws of the State of [State] in force at the date of [Decedent's] death and applicable to an intestate's separate personal property.

B. [Decedent's] five heirs [referred to throughout this private letter ruling as Beneficiaries] and the share allocated to each of them are: [Spouse] (1/3); [Son 1] (1/6); [Daughter] (1/6); [Son 2] (1/6); and [Son 3] (1/6).

C. Each [Beneficiary] succeeded to the rights that [Decedent] has as the "Beneficiary" under the terms of the Trust Agreement, so that each of them became the "Beneficiary" with respect to his or her own share.

III. After [Decedent's] death, the Trust will be accounted for as separate shares.

A. Decisions regarding distributions of "Net Profits" (as "net profits" is used in the Trust Agreement) will be made separately for each share.

B. Undistributed Net Profits of any share will be added to that share.

IV. Each [Beneficiary] will have the right to assign his or her interest in the Trust (i.e., the Trust Agreement does not have a spendthrift clause).

V. Each [Beneficiary] will have an unrestricted testamentary right to appoint his or her share of the Trust if he or she dies before the Trust terminates.

VI. If a [Beneficiary] dies within 21 years after [Decedent's] death without appointing his or her share of the Trust, then pursuant to the terms of the Trust Agreement, the [Beneficiary's] entire share in the Trust (the income interest, the remainder interest and the power of appointment) will pass to the persons who are the [Beneficiary's] heirs determined in accordance with the intestacy laws of the State of [State] in force at the date of the [Beneficiary's] death and applicable to an intestate's separate personal property.

VII. If a [Beneficiary] disclaims a remainder interest and a power of appointment (but not an income interest) and if the [Beneficiary] survives for 21 years after [Decedent's] death, the [Beneficiary's] income interest in his or her share will terminate on [Date 2] (21 years after [Decedent's] death) and the disclaimed portion of the remainder interest in his or her

share will pass to the persons who would have been the [Beneficiary's] heirs determined as if the [Beneficiary] had died on [Date 2] in accordance with the intestacy laws of the State of [State] then in force and applicable to an intestate's separate personal property.

VIII. When the Trust terminates on [Date 2] (21 years after [Decedent's] death), any property that would pass to a person who has not yet reached his or her 35<sup>th</sup> birthday will be retained in a vested interest trust for that person.

The parties propose to petition Court for approval of the terms of Agreement. The parties to the petition include guardians ad litem for minor and unborn beneficiaries. The proposed Order by Court would enter a judgment construing the Trust as set forth in Agreement and declaring as follows:

A. From the time of [Decedent's] death: (i) proper accounting requires that the Trust be accounted for as separate shares for [Decedent's] heirs and the heirs or appointees of any other Beneficiary, each of whom becomes the Beneficiary of his or her share, and that each such Beneficiary succeeds to the rights with respect to his or her own share that [Decedent] had as the Beneficiary under the terms of the Trust Agreement; (ii) each such share is separate, and the Beneficiaries do not become common beneficiaries of an undivided trust; and (iii) consequently, the interests and power of a Beneficiary with respect to his or her share extend only to that Beneficiary's respective share and not to any share held for any other Beneficiary.

B. Decisions regarding distributions of "Net Profits" (as "net profits" is used in the Trust Agreement) will be made separately for each share, with undistributed Net Profits of any share added to the principal of that share.

C. A Beneficiary may disclaim all or a portion of his or her interest in the remainder interest and a commensurate part of his or her testamentary general power of appointment, without disclaiming (i.e., while retaining) a commensurate part of his or her income interest, with the result that the disclaimed remainder interest will pass to others even though the disclaimant may be living when, and receiving distributions of income until, the Trust terminates.

D. If a Beneficiary (a) disclaims his or her remainder interest in, and testamentary general power of appointment over, all or part of his or her share (but does not disclaim the income interest in that share or part thereof) and (b) survives for 21 years after [Decedent's] death, then the Beneficiary's income interest in the share will terminate on Date 2, (21 years after [Decedent's] death), the Beneficiary will have no right to affect the disposition of the disclaimed portion, and thus the disclaimed portion of the remainder interest in the share will pass to the persons who would be the Beneficiary's heirs, determined as if the Beneficiary had died on

Date 2, and in accordance with the intestacy laws of [State] then in force and applicable to an intestate's separate personal property.

E. If a Beneficiary (a) disclaims his or her remainder interest in, and testamentary general power of appointment over, all or part of his or her share (but does not disclaim the income interest in that share or part thereof), and (b) dies within 21 years of [Decedent's] death, then (i) the disclaimer shall be of no effect with respect to the disclaimed remainder interest (because under the Trust Agreement only persons who are then living will share in the remainder of the Trust when the Trust terminates), (ii) on the Beneficiary's death, with respect to any disclaimed portion, the beneficial ownership of the Beneficiary's share cannot be diverted (because the power of appointment exercisable at the Beneficiary's death was disclaimed and does not pass to any other person) and thus will pass to the Beneficiary's heirs determined at the Beneficiary's death under the applicable intestacy laws of [State] then in force that govern an intestate's separate personal property and (iii) on the Beneficiary's death, with respect to any undisclaimed portion, the beneficial ownership of the Beneficiary's share will pass to the Beneficiary's heirs determined at the Beneficiary's death under the applicable intestacy laws of [State] then in force that govern an intestate's separate personal property, but only to the extent that the Beneficiary does not exercise his or her testamentary general power of appointment over the undisclaimed portion.

F. Under current law, a surviving spouse is an heir with respect to property. If current law remains unchanged, the surviving spouse of a Beneficiary would succeed to a portion of the Beneficiary's share (as an heir of the Beneficiary) if (a) the Beneficiary dies within 21 years of [Decedent's] death or (b) the Beneficiary disclaims and survives until the Trust terminates. With respect to the latter event, if a Beneficiary (i) disclaims a remainder interest in, and testamentary general power of appointment over, all or part of his or her share (but does not disclaim the income interest in that share or part thereof) and (ii) survives until the Trust terminates, if current law remains unchanged, the person who is the spouse of the Beneficiary at the time of the trust's termination succeeds to a portion of the Beneficiary's share (as a person who would be an heir of the Beneficiary if the Beneficiary had died at the time of the Trust's termination). In either event, to the extent the spouse of a Beneficiary disclaims his or her interest in the Beneficiary's share, the beneficial ownership of the Beneficiary's share shall pass as if that spouse had predeceased the Beneficiary and neither that spouse nor any heir of that spouse (as such, but not as an heir of the Beneficiary) will have any interest in such Beneficiary's share; however, any such disclaimer shall not affect the rights of any subsequent spouse of such Beneficiary.

In addition, the proposed Order would modify the Trust to add the following provision to the end of Article IV of the Trust:

Section 5. Notwithstanding Section 3 of this Article IV, if property is to be distributed upon the termination of the trust (the "Original Trust") to a person who has not then attained thirty-five years of age, the Trustee shall, anything in this Agreement and Declaration of Trust notwithstanding, and even though that property is vested in that person, make payment or distribution of that property to the Trustee to be held in a trust for that person under this Section 5 (a "Section 5 Trust"). If that person attains thirty years of age after the termination of the Original Trust, one-half of the funds held for that person shall be distributed to that person free of trust, with the other half continuing to be held in trust until that person attains thirty-five years of age; provided, however, that while the person is under age thirty-five years of age, the trustee may withhold any of the property otherwise distributable as long as the trustee believes that it would not be in the best interests of the person to receive such property before attaining age thirty-five. If that person has attained thirty years of age upon the termination of the Original Trust but not thirty-five years of age, then only one-half of that property shall be held in trust for that person, with the other half distributed to that person outright and free of trust upon the termination of the Original Trust; provided, however, that while the person is under age thirty-five years of age, the trustee may withhold any of the property otherwise distributable as long as the trustee believes that it would not be in the best interests of the person to receive such property before attaining age thirty-five. Any Section 5 Trust shall be held until the person for whom it is held attains thirty-five years of age or dies, whichever event occurs first. At that time, Trustee shall pay all property then on hand in that person's Section 5 Trust to that person or if that person is not then living, as that person may appoint by his or her will (including to that person's estate or to the creditor's of that person or that person's estate). If that person is not then living and fails to exercise his or her testamentary general power of appointment set forth in the preceding sentence, Trustee shall pay all property then on hand in that person's Section 5 Trust to the personal representative of that person's probate estate. Equitable title to the property held in that person's Section 5 Trust shall be vested in that person and alienable. No election shall be made so as to violate any applicable rule against perpetuities or rule against restraint on alienation. While property is held in that person's Section 5 Trust, the net income and principal thereon in whole or in part may be paid to that person to such extent as Trustee in its sole judgment may determine.

The following disclaimers are proposed:

1. Spouse proposes to disclaim an amount equal to the Disclaimed Fraction of the remainder of her share of the Trust; the power of appointment with respect to the Disclaimed Fraction of her share of the Trust; and each interest to which Spouse may become entitled with respect to each disclaiming person's share, if the disclaimer giving rise to such interest is effective on or before Date 3. The Disclaimed Fraction for Spouse is a.

2. Son 1 proposes to disclaim an amount equal to the Disclaimed Fraction of the remainder of his share of the Trust; the power of appointment with respect to the Disclaimed Fraction of his share of the Trust; and each interest to which Son 1 may become entitled with respect to each disclaiming person's share, if the disclaimer giving rise to such interest is effective on or before Date 3. The Disclaimed Fraction for Son 1 is b.

3. Son 2 proposes to disclaim an amount equal to the Disclaimed Fraction of the remainder of his share of the Trust; the power of appointment with respect to the Disclaimed Fraction of his share of the Trust; and each interest to which Son 1 may become entitled with respect to each disclaiming person's share, if the disclaimer giving rise to such interest is effective on or before Date 3. The Disclaimed Fraction for Son 2 is c.

4. Son 3 proposes to disclaim an amount equal to the Disclaimed Fraction of the remainder of his share of the Trust; the power of appointment with respect to the Disclaimed Fraction of his share of the Trust; and each interest to which Son 3 may become entitled with respect to each disclaiming person's share, if the disclaimer giving rise to such interest is effective on or before Date 3. The Disclaimed Fraction for Son 3 is d.

5. Daughter proposes to disclaim an amount equal to the Disclaimed Fraction of the remainder of her share of the Trust; the power of appointment with respect to the Disclaimed Fraction of her share of the Trust; and each interest to which Daughter may become entitled with respect to each disclaiming person's share, if the disclaimer giving rise to such interest is effective on or before Date 3. The Disclaimed Fraction for Daughter is e.

6. Spouse 1, Spouse 2, and Spouse 3 each propose to disclaim any future interest in the Trust that her or she may have as a New Trust Beneficiary. Specifically, Spouse 1, Spouse 2, and Spouse 3 will disclaim all Future Income Interests to which he or she may become entitled; all Future Powers of Appointment to which he or she may become entitled, and all Future Remainder Interests to which he or she may become entitled.

Each Disclaimant represents that he or she has not exercised dominion or control over any interest in the Trust, nor have they received or accepted any rights, titles, power or interests in or benefits under the Trust.

Under State Statute #1, acceptance by a beneficiary of an interest in a trust is presumed. A beneficiary of a trust may disclaim an interest in the trust, in whole or in



part. The disclaimer must be in writing, evidencing the disclaimant's irrevocable and unqualified refusal to accept the interest, and delivered to the trustee no later than nine months after the later of (1) the day on which the transfer creating the interest in the beneficiary is made; (2) the day on which the beneficiary attains age 21; or (3) in the case of a future interest, the date of the event that causes the taker of the interest to be finally ascertained and the interest to be indefeasibly vested.

Under State Statute #1, a disclaimer is effective as of the date of the transfer of the interest involved and relates back for all purposes to the date of the transfer and is not subject to the claims of any creditor of the disclaimant. Unless the terms of the trust provide otherwise, the interest that is the subject of the disclaimer passes as if the person disclaiming had predeceased the transfer and a future interest that would otherwise take effect in possession or enjoyment after the termination of the estate or interest that is disclaimed takes effect as if the disclaiming beneficiary had predeceased the transfer.

Under State Statute #2, the terms of a trust may be modified as long as the change is not inconsistent with a material purpose of the trust and provided that all beneficiaries of the trust have consented to the order or are deemed to have consented to the order.

You have represented that there have been no additions to the Trust after September 25, 1985.

The following rulings have been requested:

1. The Decedent had a general power of appointment created before October 22, 1942, with respect to the Trust, the release or lapse of which is nontaxable for federal estate and gift tax purposes with respect to the Decedent. The Decedent's power lapsed at his death on Date 1, and thus the trust is not included in Decedent's gross estate.

2. Each Beneficiary's power of appointment over his or her respective share of the Trust is a general power of appointment created on or before October 21, 1942.

3. A court order that adopts the terms of the Agreement in the form of the proposed order will not result in: (a) a taxable gift for federal gift tax purposes by any of the Beneficiaries; (b) inclusion of any portion of the Trust in the gross estate of any Beneficiary whose death occurs prior to termination of the Trust; or (c) a loss of GST tax effective date exempt status for any portion of the Trust.

4. The proposed disclaimers of interests in the Trust by any of the Beneficiaries: (a) will be qualified disclaimer and will not result in a taxable gift for federal gift tax purposes by any of the Beneficiaries; (b) will not subject any portion of the Trust to federal estate tax in the gross estate of any Beneficiary; and (c) will not result in a loss of GST tax effective date exempt status with respect to any portion of the Trust.

LAW AND ANALYSIS:Ruling Requests 1 and 2

Section 2041(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent (A) by will, or (B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§2035 to 2038, inclusive; but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof.

Section 2041(b)(1) defines the term "general power of appointment" as a power exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or creditors of the decedent's estate.

Section 20.2041-1(b) of the Estate Tax Regulations states that a power of appointment includes all powers that are in substance and effect powers of appointment, regardless of the nomenclature used in creating the power.

Section 20.2041-2(d) provides that a failure to exercise a general power of appointment created before October 22, 1942, or a complete release of the power is not an exercise of the power. The phrase "a complete release" means a release of all powers over all or part of the property subject to the power of appointment, as distinguished from the reduction of a power of appointment to a lesser power. Thus, if the decedent completely relinquished all powers over one-half of the property subject to a power of appointment, the power is completely released as to that one-half.

Section 2514(a) provides that an exercise of a general power of appointment created on or before October 21, 1942, shall be deemed a transfer of property by the individual possessing such power, but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof.

Section 25.2514-2(c) of the Gift Tax Regulations provides that a failure to exercise a general power of appointment created on or before October 21, 1942, or a complete release of such a power is not considered to be an exercise of a general power of appointment. The phrase "a complete release" means a release of all powers over all or a portion of the property subject to a power of appointment, as distinguished from the reduction of a power of appointment to a lesser power. Thus, if the possessor completely relinquished all powers over one-half of the property subject to a power of appointment, the power is completely released as to that one-half.

The Trust was created in Year, prior to October 22, 1942. During his life, Decedent was the sole beneficiary of the Trust. Under Section 3 of Article III, Decedent was granted a general power to appoint the income and corpus of the Trust. If Decedent did not exercise this power, the power would lapse at his death and Decedent's heirs under the laws of descent and distribution would, as takers in default of his exercise of the power, succeed him as beneficiaries of the Trust. Decedent did not exercise his power. Therefore, under Article III, Section 3 of the Trust, Decedent's

heirs under State law succeed him as beneficiaries of the Trust. Decedent's heirs under State law are Decedent's spouse, Spouse, who will receive a one-third share of the Trust, and Decedent's four children, Son 1, Son 2, Son 3, and Daughter, each of whom will receive a one-sixth share of the Trust (collectively referred to as the Beneficiaries).

Based on the facts submitted and the representations made, we conclude that Decedent possessed a general power of appointment created before October 22, 1942. Because Decedent did not exercise his general power of appointment, the power lapsed on Decedent's death. A lapse of a power created prior to October 22, 1942, is not an exercise of that power. Therefore, the Trust is not included in Decedent's gross estate for federal estate tax purposes.

In addition, as discussed above, under Section 3 of Article III, each Beneficiary of the Trust was granted a general power to appoint the income and corpus of the Trust. If a Beneficiary did not exercise this power, the power would lapse at his or her death and the Beneficiary's heirs under the laws of descent and distribution would, as takers in default of his or her exercise of the power, succeed him as Beneficiaries of the Trust. Section 3 specifically states that the term "Beneficiary" applies not only to Decedent, but to all his successors to beneficial interests under the Trust. Therefore, based on the facts submitted and the representations made, we also conclude that each Beneficiary's power of appointment over his or her respective share of the Trust is a general power of appointment created before October 22, 1942.

### Ruling Request 3

#### Generation-skipping transfer tax

Section 2601 imposes a tax on each generation-skipping transfer. Section 2611(a) defines a generation-skipping transfer to mean (1) a taxable distribution, (2) a taxable termination, or (3) a direct skip.

Section 1433(a) of the Tax Reform Act of 1986 (TRA of 1986) provides that, except as provided in §1433(b), the GST tax applies to generation-skipping transfers made after October 22, 1986.

Section 1433(b)(2)(A) of the TRA of 1986 provides that the GST tax does not apply to transfers under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides that a trust qualifies for transitional rule relief from the provisions of Chapter 13 of the Code, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under §26.2601-1(b)(1)(ii)(A), any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in a grantor's gross estate under §§2038 and 2042).

Section 26.2601-1(b)(1)(iv) provides that an addition made after September 25, 1985, to an irrevocable trust will subject to the provisions of Chapter 13 a proportionate amount of distributions from, and terminations of interests in, property held in the trust.

Generally, if any portion of a trust remains in the trust after the taxable exercise, release, or lapse of a general power of appointment over that portion of the trust, the value of the entire portion of the trust subject to the power that was exercised, released, or lapsed will be treated as an addition to the trust. However, the portion of a trust that remains after a nontaxable release or lapse of a general power of appointment is not treated as a constructive addition. See §26.2601-1(b)(1)(v).

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purpose of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to chapter 13, if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the position of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(E), Example 5, describes a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute

income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The example concludes that the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i)(E), Example 3, illustrates a situation where the trustee of a trust files a construction suit with the appropriate local court to resolve an ambiguity in the trust instrument and the court issues an order construing the terms of the trust instrument. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to chapter 13.

In this case, the Trust was irrevocable on September 25, 1985. As noted above, the lapse of Decedent's general power of appointment with respect to Trust did not constitute a taxable transfer for estate or gift tax purposes. Further, it is represented that there have been no actual or constructive additions to the Trust after September 25, 1985. Accordingly, the Trust is exempt from GST tax under § 26.2601-1(b)(1).

Term I of Agreement provides that Decedent had an unrestricted right to appoint his interest in the Trust. Term II provides that Decedent's interest in the Trust passed to his heirs, the identity of Decedent's heirs and the share allocated to each heir under State law. Term II also addresses beneficiaries who succeed to Decedent's rights under the Trust. Terms I and II restate and clarify the provisions of the Trust. See § 26.2601-1(b)(4)(i)(E), Example 3.

Term III and Paragraphs A and B of the proposed Order provide that, after the Decedent's death, the Trust will be accounted for as separate shares. Term III is similar to the modification described in § 26.2601-1(b)(4)(i)(E), Example 5.

Term IV provides that each Beneficiary has the right to assign his or her interest in the Trust. Term V provides that each Beneficiary has an unrestricted testamentary right to appoint his or her share of the Trust if he or she dies before the Trust terminates. Pursuant to Term VI, if a Beneficiary dies within 21 years after the Decedent's death without appointing his or her share, the Beneficiary's entire share will pass to the persons who are the Beneficiary's heirs determined in accordance with the intestacy law of State in force at the date of the Beneficiary's death. Terms IV, V, and VI are consistent with the Trust and clarify the provisions of the Trust. See § 26.2601-1(b)(4)(i)(E), Example 3.

Term VII provides that if a Beneficiary disclaims a remainder interest and a power of appointment, but not an income interest, and if the Beneficiary survives for 21 years after Decedent's death, the Beneficiary's income interest in his or her share will terminate on Date 2, and the disclaimed portion of the remainder interest in his or her share will pass to the persons who would have been the Beneficiary's heirs determined as if the Beneficiary had died on Date 2. Paragraphs C, D, E, and F of the proposed Order also address the proposed disclaimers.

Article III, Section 3 of the Trust provides that, "[a]t the time of the death of Beneficiary, his equitable interest in said Trust Estate, unless disposed of otherwise by said Beneficiary, shall pass to and vest in his heirs in accordance with the laws of descent and distribution then in force, applicable to the equitable interest of such Beneficiary in said Trust." The Trust does not specifically provide for disclaimers by a beneficiary. Pursuant to State Statute #1, a disclaimer is effective as of the "date of the transfer of the interest involved" and relates back for all purposes to the "date of the transfer."

State Statute #1 does not define the word "transfer." In the present case, the meaning of "transfer," and thus when a disclaimant is deemed to have died, affects who takes a disclaimed remainder interest. If the disclaimant is deemed to have died immediately before the remainder becomes possessory, the takers are the Beneficiary's heirs. If the Beneficiary is deemed to have predeceased either the creation of the Trust or the Decedent's death, the remainder would pass to the Decedent's heirs. The heirs of Decedent differ from the heirs of the disclaiming Beneficiaries. Term VII represents the parties' resolution of this issue.

Certain parties propose to disclaim all or a portion of their remainder and the power of appointment with respect to the disclaimed portion, but will retain their current income interest with respect to the disclaimed portion. A power of appointment is

personal to the donee. If the donee dies, the power terminates. See Simes and Smith, The Law of Future Interests, § 943.

Based on the facts and representations, Term VII is a settlement of a bona fide issue, represents a compromise between the positions of the parties, and reflects the parties' assessments of the relative strengths of their positions. Term VII of Agreement is within the range of reasonable outcomes.

Term VIII and the addition of Article VI, Section 5 to the Trust under the proposed Order provide that any property that would pass to a person who has not yet reached his or her 35<sup>th</sup> birthday will be retained in a vested interest trust for that person. Article IV, Section 3 of the Trust provides for outright distribution to the beneficiaries on the Trust's termination. Unlike the above-discussed terms, Term VIII proposes a specific modification to the Trust. Under Term VIII, the assets in each trust will immediately vest in the named beneficiary and will be held for the exclusive benefit of the named beneficiary. Each such beneficiary will have a testamentary general power of appointment. If a beneficiary fails to exercise such power, the trust property will be distributed to the beneficiary's estate. Therefore, if not earlier terminated through distributions to the named beneficiary, on the death of the named beneficiary, any remaining principal and undistributed income will be includible in the beneficiary's gross estate of federal estate tax purposes. Under these circumstances, Term VIII does not shift a beneficial interest in the Trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification nor does Term VIII extend the time for vesting of any beneficial interest in the Trust beyond the period provided in the Trust.

Based on the facts submitted and representations made, we conclude that a court order that adopts the proposed terms under Agreement will not subject the Trust, the separate shares created under Term III of Agreement, or any distributions therefrom to the GST tax imposed by § 2601.

### Gift Tax

Section 2501(a) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another, the gift is complete. But,

if upon a transfer, a donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the fact in the particular case.

Section 25.2511-1(c)(1) provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-75 (9<sup>th</sup> Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

As discussed above, Term VII of Agreement represents the resolution of a bona fide controversy between the parties and the proposed settlement is based on arm's length negotiations among all the interested parties. Other than Spouse 2, all parties who hold an interest in the Trust, including any minors and unborn heirs, have been represented in the negotiations that preceded the proposed Order that incorporates the Agreement. With respect to Terms I, II, III, IV, V, VI, and VIII, the interests of the parties remain the same after the Agreement.

The terms of Agreement clarify ambiguous terms of the Trust and are reflective of the rights of the parties under applicable State law that would be applied by the highest court of State. Accordingly, based on the facts submitted and representations made, we conclude that a court order that adopts the terms of Agreement will not cause any of the beneficiaries to have made a taxable gift for purposes of the federal gift tax under § 2501.

### Estate Tax

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his or her death.

Section 2036 provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or



for any period which does not in fact end before his death: (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037 provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if: (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds five percent of the value of such property.

Section 2038(a)(1) provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In order for §§ 2036-2038 to apply, a decedent must have made a transfer of property of any interest therein (except in case of a bona fide sale for adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property.

In the present case, the terms of Agreement do not constitute transfers within the meaning of §§ 2036-2038. Therefore, based on the facts and representations, we conclude that a court order that adopts the terms of Agreement will not result in inclusion of any portion of the Trust in the gross estate under §§ 2036-2038 of any beneficiary whose death occurs prior to the termination of the Trust.

#### Ruling Request 4

Section 2046 provides that for estate tax purposes, disclaimers of property interests passing upon death are treated as provided in § 2518.

Section 2518(a) provides that, if a person makes a qualified disclaimer with respect to any interest in property, then for purposes of the estate and gift tax the disclaimed interest is treated as if it never passed to that person.

Section 2518(b) defines a qualified disclaimer as an irrevocable and unqualified refusal by a person to accept an interest in property but only if --

- (1) the refusal is in writing,

(2) the writing is received by the transferor of the interest, the transferor's legal representative, or the holder of the legal title to the property to which the interest relates not later than the date that is 9 months after the later of --

(A) the date on which the transfer creating the interest in the person is made, or

(B) the day on which the person attains age 21,

(3) the person disclaiming the interest has not accepted the interest or any of its benefits, and

(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either --

(A) to the spouse of the decedent, or

(B) to a person other than the person making the disclaimer.

Section 2518(c)(1) provides that a disclaimer with respect to an undivided portion of an interest which meets the requirements of § 2518(b) shall be treated as a qualified disclaimer of such portion of the interest.

Under § 25.2518-1(b), if a qualified disclaimer is made, the property is treated, for federal gift, estate, and generation-skipping transfer tax purposes, as passing directly from the transferor, and not from the disclaimant, to the person entitled to receive the property as a result of the disclaimer. Thus, the disclaimant is not treated as making a gift.

Section 25.2518-3(a)(1)(i) provides that if the requirements of the section are satisfied, the disclaimer of all or an undivided portion of any separate interest in property may be a qualified disclaimer, even if the disclaimant has another interest in the same property. Section 25.2518-3(a)(1)(iii) provides that a power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard.

Section 25.2518-3(b) provides that the disclaimer of an undivided portion of a separate interest in property which meets the other requirements of a qualified disclaimer under § 2518(b) and the corresponding regulations is a qualified disclaimer. An undivided portion of a disclaimant's separate interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property and must extend over the entire term of the disclaimant's interest in such property. See § 25.2518-3(d), Example 20, regarding the disclaimer of a fractional share of a residuary bequest.

Section 25.2518-2(c)(3) provides that, for purposes of the time limitation, the 9-month period from making a disclaimer generally is to be determined with reference to the taxable transfer creating the interest in the disclaimant. In the case of a general power of appointment, the holder of the power has a 9-month period after the creation of the power in which to disclaim. A person to whom any interest in property passes by reason of the exercise or lapse of a general power may disclaim such interest within a 9-month period after the exercise or lapse.

In the present case, Spouse, Son 1, Son 2, Son 3, Daughter, Spouse 1, Spouse 2, and Spouse 3 each propose to disclaim the above described interests in the Trust. Each disclaimer will be in writing. Each disclaimant represents that he or she has not accepted any benefits in the property subject to the disclaimers, and that the disclaimers are valid under State law. The disclaimed interest will pass without any direction on the part of any disclaimant. As discussed above, Decedent's power of appointment under Trust was created before October 22, 1942, and is a general power of appointment described in §§ 2041(a)(1) and 2514(a). Decedent did not exercise his power and, therefore, under § 25.2518-2(c)(3), the period for making the disclaimer is measured from the date of Decedent's death, the date when the interest is deemed created.

Based on the facts and representations, if the proposed disclaimers by Spouse, Son 1, Son 2, Son 3, Daughter, Spouse 1, Spouse 2, and Spouse 3 are delivered to trustee within nine months of Decedent's death, and provided the disclaimers are valid under State law, the disclaimers will be qualified disclaimers for purposes § 2518. Therefore, the disclaimers by any of the Beneficiaries will not result in a taxable gift for federal gift tax purposes by any of the Beneficiaries, will not subject any portion of the Trust to federal estate tax in the gross estate of any Beneficiary, and will not result in a loss of GST tax effective date exempt status with respect to any portion of the Trust. It should be noted, however, that a recipient of a disclaimed interest under the above-proposed disclaimers must disclaim that interest within 9 months of Date 1. See § 25.2518-2(c)(3).

The rulings contained in this letter are based upon information submitted and representations made by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

James F. Hogan  
Senior Technician Reviewer, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes  
Copy of this letter

cc: